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**Reserve Bank Announces Monetary Policy Measures**

There have been significant macroeconomic developments since the Third Quarter Review of Monetary Policy in January 2010. On the growth front, the advance estimates by the CSO for 2009-10 and for Q3 of 2009-10 suggest that the recovery is consolidating. Data on industrial production currently available up to January 2010 show that the uptrend is being maintained. The manufacturing sector, in particular, has recorded robust growth. The sharp acceleration in the growth of the capital goods sector points to the revival of investment activity. After contracting for 13 straight months, exports have expanded since November 2009. That the recovery is gaining momentum is also evident from the sustained increase in bank credit and the resources raised by the commercial sector from non-bank sources. Even as this is happening against the backdrop of improving global conditions, recent real GDP and industrial production clearly suggest that the positive trend is predominantly due to domestic factors.

The developments on the inflation front, however, are a source of growing concern. Notwithstanding some moderation in recent weeks, food prices remain at elevated levels. In fact, consumer price inflation, as measured by various consumer price indices, has accentuated further. The acceleration in the prices of non-food manufactured goods and fuel items in recent months has been of particular concern.

In the Third Quarter Review of Monetary Policy in January 2010, the Reserve Bank had raised the CRR by 75 basis points in two stages. This reflected the growing confidence in the economy and the risk of supply side inflation spilling over into a wider inflationary process. However, the policy rates were left unchanged as it was felt that the recovery was still to fully take hold and that pre-mature tightening might undermine the recovery process. Subsequent developments show that the recovery is increasingly taking hold. On the other hand, inflationary pressures have accentuated and have been spilling over to the wider inflationary process. The recent industrial production data suggest revival of private demand, which could potentially add to inflationary pressures.

Anchoring inflation expectations and containing overall inflation have become imperative. Headline WPI inflation on a year-on-year basis at 9.9 per cent in February 2010 has exceeded our baseline projection of 8.5 for end-March 2010 set out in the Third Quarter Review. Year-on-year WPI non-food manufacturing products (weight: 52.2 per cent) inflation, which was negative (-0.4 per cent) in November 2009, turned marginally positive (0.7 per cent) in December 2009 and rose sharply thereafter to 2.8 per cent in January 2010 and further to 4.3 per cent in February 2010. Year-on-year fuel price inflation also surged from (-)0.8 per cent in November 2009 to 5.9 per cent in December 2009, to 6.9 per cent in January 2010 and further to 10.2 per cent in February 2010. With rising demand side pressures, there is risk that WPI inflation may cross double digits in March 2010.

To sum up, since the Third Quarter Review in January 2010, while the recovery in growth has proceeded broadly along expected lines, the inflationary pressures have intensified beyond our baseline projection. Even as food prices are showing signs of moderation, they remain elevated. More importantly, the rate of increase in the prices of non-food manufactured goods has accelerated quite sharply. Furthermore, increasing capacity utilisation and rising commodity and energy prices are exerting pressure on overall inflation. Taken together, these factors heighten the risks of supply-side pressures translating into a generalised inflationary process.

**Policy Measures**

The Third Quarter Review had mentioned that our instruments of monetary policy are all currently at levels that are more consistent with a crisis situation than with a fast recovering economy. In the emergent scenario, low policy rates can complicate the inflation outlook and impair inflationary expectations, particularly given the recent escalation in the prices of non-food manufactured goods. The Third Quarter Review had also indicated that the Reserve Bank would take further action as warranted. Our assessment is that at the this juncture further policy action is warranted. Given the lags in monetary policy, it is better to respond in a timely manner, even if it is outside the scheduled policy reviews, than take stronger measures at a later stage when inflationary expectations have accentuated. Therefore, as a part of the calibrated exit strategy, initiated in the Second Quarter Review in October 2009 and carried forward in the Third Quarter Review in January 2010, it has been decided :

- to raise the repo rate under the Liquidity Adjustment Facility (LAF) by 25 basis points from 4.75 per cent to 5.0 per cent with immediate effect.

- to raise the reverse repo rate under the LAF by 25 basis points from 3.25 per cent to 3.5 per cent with immediate effect.

These measures should anchor inflationary expectations and contain inflation going forward. As liquidity in the banking system will remain adequate, credit expansion for sustaining the recovery will not be affected.

The Reserve Bank will continue to monitor macroeconomic conditions, particularly the price situation, and take further action as warranted.

**G. Raghuraj**
Deputy General Manager

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